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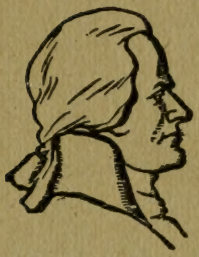
[Modern business Talks]

Our Better Banking System

All business rises or falls with the flow of currency and credit. Nothing is more vital to the executive or more interesting to his ambitious associate than to know the forces that affect the flow.



MODERN BUSINESS
TALK No. 32
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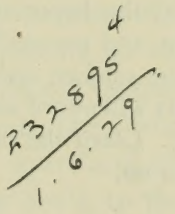
Our Better Banking System

This Talk, to be read in connection with Volume 16, forms part of READING ASSIGNMENT 32



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READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Pages 176-339 of Volume 16, "Banking", and (3) Problem 16.

One of the best ways to keep your interest in a subject keen, and to make sure that the details of it are properly pigeonholed in your memory for future use, is to discuss it with someone else. The effort to recall all of the important points, to get them in the right order and perspective, ends by making you a master of the subject, and the facility which you gain by the effort will afford as much pleasure to others as to yourself. Learn the principles and the facts. Then pass them on.

Our Better Banking System

"Morris' idea in establishing the bank (Bank of North America) was that it would economize the use of cash. His task at the time was to finance the Revolution."—Page 176, Chapter XI, Volume 16 of the MODERN BUSINESS Text.

There is an outdoor game we boys used to call "snap-the-whip." You formed a long line, joined hands and ran forward. When the line got up sufficient speed, the big boy at the "handle" end of the "whip" "snapped" it by suddenly turning and pulling the other way. Away flew the fellows on the "snapper" end, hurled along at breakneck speed, taking seven-league strides, until at length the force of centrifugal motion tore their hands apart and all but the stoutest went tumbling head over heels, to the accompaniment of loud shouts of laughter.

I surmise that most of us, when we grow up, find a good deal in business to remind us of that old game. For instance, after a period of dulness, business slowly gets under way. Business men move forward together, as if with joined hands. The walk becomes a trot, the trot a run. Business is now booming. The "snapper" end is going at a furious gallop.

But the conservatives see danger ahead and pull up. The line pivots. The little fellows on the tip are pulled along faster and faster and at last, just when to them things seem to be going at a fine speed, snap! goes the "whip" and they are flung off into the head-over-heels of financial ruin.

One of the leading objects of the new banking and currency system, which went into effect in 1914, was to put an end to "snapping the whip" as a business pastime. The previous system had made it inevitable. Game and system, they had together cost the country a minimum of five panics and two currency agitations, all in less than fifty years. In every crisis, it was always the banks, first of all our institutions, that started wabbling. Today, just as conspicuously, it has been the banking system that has stood firm and helpful in the midst of a good deal of uncertainty and disorganization.

For what is admittedly an experiment in national banking, that is doing pretty well.

Still, it is an experiment, and we must look it over. How does it compare with the old system? In what respects is it an improvement? Will it always suffice to keep business in the "middle of the road" and prevent overtrading? Will it head off panics? Is our currency "elastic" now? Will our money rates remain low and legitimate borrowing be easier?

Taking the System Apart

Business men all over the country are interested in these details and are becoming very much alive to the

need for fullest light on them, and the conversation which a professional auditor recently had with a banker friend is doubtless being duplicated in scores of other communities.

"I have run into two or three questions", the auditor said, "which show me I must freshen up on the Federal Reserve System. A client asked me the other day what I thought of the trade acceptance. His credit man, he said, was strongly in favor of pushing the idea, but he himself was a little afraid of antagonizing his trade. Of course, I indorsed the acceptance, but at the same time I was a little hazy in my details."

The banker nodded.

"Then I spent last week out in a small city of Ohio", the auditor continued. "One of my clients there, a manufacturer, is also director of a local bank. This bank had not been extending all the accommodation it might have given to its customers, nor carrying as much of the Liberty Loan as it should. My client wanted to send a part of its paper to the reserve bank for rediscount, but he couldn't get his fellow directors to agree with him. They were afraid the community would take it as a sign of weakness. He sounded me on my views."

"I know that is the feeling in some small places", said the banker friend, "but they are growing out of it. The sentiment in the large centers has been entirely different."

"I understood so", said the auditor, "but even here, I am told, there is room for education. And that puts

it up to me, along with the rest of the business world, to inform myself. Now, I'd like to check up with you on some things."

Using Credit at Home

"I am curious to know what you consider the greatest gain from the new system", remarked the banker.

"Well", replied the auditor, "if the former congestion of money in New York has been overcome, if our gold and currency supply has been mobilized and in this way funds have been made more available to business all over the country, I certainly should consider that the most fundamental improvement. The merchant out in Oklahoma, or Wisconsin, or Nevada is now going to have the same chance for accommodation that the speculator in Wall Street has. Am I right?"

"I think you are", said the banker. "A good many banks in and out of New York used to keep balances with their correspondent banks there to cover exchange; a good many others used to send in their surplus funds from time to time for temporary investment. Practically all these were loaned out 'on call', and, as Wall Street provided most of this demand, that put a premium on speculation at the expense of the home communities in Oklahoma, Nevada and the rest of the States. Nowadays, on the contrary, the commercial paper furnished by those home communities is as good as, or better than, the Wall Street call loans, because it can be rediscounted at need with the Federal Reserve Banks."

"But isn't the Federal Reserve system practically confined to national banks?" asked the auditor.

"The State banks and trust companies are coming in rapidly. So there probably will be no 'bank war', such as was feared at first by some."

Coordinating the Banking System

"And it is a system of independent banks?" asked the auditor. "I mean, are they not more independent of Wall Street and the big interests than before?"

"Well", replied the banker, "isn't the fact that all banks the country over have been able to participate in the Liberty Loans and carry the bonds for their subscribers a significant straw which shows which way the wind is blowing? In the old days all the responsibility and glory would have gone to a few big banks."

"All right", said the auditor, "I'm satisfied. You know a lot of business men are still waiting to be 'shown' on that head. Now let's come back to the big features. These twelve Reserve Banks all work together, in a way, under the Reserve Board and the gold and currency supply moves back and forth wherever it is needed, as I understand it, instead of being congested in one place, or being hoarded."

Controlling the System

"The twelve Reserve Banks", said the banker, "are like twelve reservoirs of water, all connected. You can dip out of one reservoir and pour into another, but the water all comes back to the same level in all."

"Isn't that the one big feature that is expected to prevent panics?"

"One of the features", said the banker. "It is fundamental to the others. The rediscount power, or rather the power to raise the rediscount rate, which is very nearly as important, would be useless except for the centralized control of gold and currency."

"The rediscount power is, in fact, the power that helps protect the gold supply as well as prevent panics, I believe", said the auditor.

"To be sure. Panics and gold shortage go together", assented the banker. "As you realize, our whole credit structure is based on gold. So is that of most of the other big trading nations. When a money stringency sets in it is either because too much business is being done for the stock of gold available, or that some of the gold is being drawn away, either for hoarding or export. In either case, the procedure must be about the same. Some arbitrary action must be taken to keep the gold in the country and keep it available to business."

"There was no way of doing that before, I remember", said the auditor. "I mean no established way. In Cleveland's term, when gold was leaving the country, all we could do was to have Congress vote bond issues and the Treasury buy the gold back."

Protecting the Gold Supply

"A clumsy and expensive device", said the banker. "All important foreign central banks, on the contrary, are empowered by their governments to stop the out-

flow of gold by raising the discount rate on commercial bills. That is the same thing as raising the price of gold. We have that provision in our new system."

"How does it work?"

"It has not been tested. The movement of gold has been all the other way", said the banker. "But when the drain begins, we shall have two remedies for it of which raising the discount rate is the first. The Reserve Banks start it, the rest of us have to follow."

"That shuts off many borrowers."

"Precisely", said the banker. "Unless your need is urgent, you, for instance, will not try to borrow at the higher rate, and unless you can offer us paper that is gilt-edged, we cannot accommodate you, because we cannot rediscount it at the Reserve Bank. It is the same with all borrowers. Thus general credit is contracted. In order to get cash, owners of goods, like your clients the manufacturers and merchants, begin to shave their prices. Prices fall. Now since low prices do not encourage imports, imports fall off. When this happens, gold exports to pay for those imports fall off too, which is, you remember, the object desired. Thus normal conditions are restored."

"How simple!" said the auditor. "And the other check against gold exports?"

"If the first remedy is not wholly effective", the banker went on, "the Reserve Banks will sell abroad the securities they hold until a point is reached where the credit balance there offsets the gold exports from

the United States. The two devices operating together ought to meet any ordinary emergency."

How Panics Will Be Mitigated

"I see", said the auditor. "And the same method would prevent a panic."

"It would tend to stop it before it got started", said the banker. "At the first sign of stringency in any district, the Reserve Bank would raise the discount rate on the bank paper. Member banks would do the same to their customers. This would discourage borrowing for speculation or overtrading. The Reserve Bank would also help to relieve the tightness of the money market, it is probable, by buying paper and thus releasing funds. Then, too, there is a further provision for emergency currency."

"And if any one Reserve Bank is loaded up with paper, it can rediscount it with any other Reserve Bank?" asked the auditor.

"The Reserve Board can even order any Reserve Bank to rediscount it, if necessary", said the banker.

"The strong must help the weak", commented the auditor. "The whole scheme certainly is a tremendous gain. And taken in conjunction with our now elastic currency—you would say that it is more elastic?"

"Only in part", said the banker. "It is true that the new Federal Reserve notes are issued against certain 'eligible' commercial paper, and to a certain extent will increase with the needs of business. But we have still the old national bank-notes secured by

United States bonds, and Federal Reserve bank-notes are also issued in the same way against the bonds."

Notes Against Assets

"The change is less radical than I thought", said the auditor, "tho it is a change; the new currency, these Federal Reserve notes—not the 'bank-notes'—are based on business assets."

"Some kind of assets", corrected the banker. "Not every kind of paper is 'eligible' for rediscount. The list is long. Better read up on it again."

"Bank acceptances are included, I believe", said the auditor, "or some kinds of them. They are merely a form of trade acceptance?"

"A bank acceptance is drawn by one bank and accepted by another, for the two customers concerned."

"You keep the acceptance and other paper you discount as long as you can, or until maturity, but rediscount them with the Reserve Bank as you need the money, do you not?"

"Yes."

"But there is a market for acceptances outside of the banks and Federal Reserve Banks, I suppose?" said the auditor.

"It is widening every day", said the banker. "As you know, only a few big well-known houses have had until recently a national market for their obligations. The single-name paper of some of our best customers, or yours, absolutely would not sell in Los Angeles or Kansas City. But an acceptance made by a member bank of the Reserve System and 'eligible' for redis-

count, no matter how small or unknown the concern on whom it is drawn—that acceptance may now find a market almost anywhere in the country."

Acceptances Widen Credit Market

"Then isn't it true", asked the auditor with livelier interest, "that this provision broadens the credit field tremendously; that, for instance, it gives one of my clients a chance to borrow in many different markets, whichever market, in fact, is cheapest? The little fellow, you know, the little trader or manufacturer, can't keep bank balances in three or four different cities at once, as many large houses do. He has to pay what money brings in his local market and when money is high he is obviously at a disadvantage with respect to the big competitor who has a choice of several markets and is always getting his loans cheaper. So the new system must tend to equalize borrowing conditions."

"Assuredly", replied the banker, smiling. "That is one of the things it is for. That is why every business man is, if he only knew it, vitally interested in the use of the trade and bank acceptances. It is going to be quite a job, however, to wean a lot of them away from the open or book accounts. Take, for instance, our friend Robinson, the department-store man. Robinson habitually holds up payment for thirty days on every purchase he makes, though he never fails to take a 'cash' discount. Do you suppose he wants to give that up?"

"Oh, he'll be one of the last to come into the fold,

no doubt", said the auditor, "but there isn't a single legitimate argument that a debtor can bring against the acceptance if he really means to pay. He can get thirty, sixty, ninety days, whichever he likes. The only difference, and, I take it, the main advantage of an acceptance, is that it is a bona fide promise to pay, an actual receipt for the goods, a 'bill receivable' instead of merely an 'account receivable.' It's better business. There can be no repudiation of a bill. There will be no haggling over items. The debtor cannot help himself to an extra discount for the purpose of passing the credit along to his customers. There will be no return of goods except under agreed conditions. It will enforce caution and make for more careful buying, and, as a corollary, more careful manufacture. In fact, it will automatically jack up and save all along the line."

"I think you are right", responded the banker, "and there is a further advantage in the use of the acceptance. It gives us and many business men, too, an excellent short time use for our funds we never had before."

"Well", remarked the auditor, "I suppose we have covered the ground."

"I think of no other important development except that we are all beginning to clear bank checks on a national scale", said the banker. "That is a very important feature. It is going to facilitate and cheapen exchange."

"Good. But, now that I think of it, there has been talk of inflation."

"How can there be any inflation in the system?" asked the banker. "An excess of gold can be reduced by reversing the procedure for checking the outflow. As to the possibility of an excess of asset currency, just reflect that the Reserve Banks must keep a reserve of 40 per cent on their Reserve notes. National banks are limited in the amount of acceptances they can take by the proportion of the latter to capital and surplus."

"The 40 per cent reserve may be reduced in time of emergency, as I understand it", said the auditor.

Provision for Emergency Currency

"That is true", replied the banker, "but the tax on the excess currency will force its retirement as soon as the emergency has passed. To sum up: business will expand, up to a certain point, as fast as the advantages of acceptances and rediscounting are utilized. When that limit is reached, future expansion can come only thru an increase of banking capital. That is not inflation."

"You don't think business crises and panics entirely a matter of the past?"

"Beyond any doubt, the danger is much reduced", said the banker in conclusion, "if the Reserve Banks use the rediscounting power they possess to check overtrading and overbanking, and there is no reason to doubt they will do so. The system, in short, tho it cannot reform human nature, does provide timely warning against banking and business excesses."

Discounting a Panic

Every panic, like every war, is always going to be, in the minds of many people, the last one. Whoever reads the chapter in the current assignment on banking conditions in this country before the Civil War, and from then up to the present World War, and then compares them with the systems of Europe, with the much-praised system of Canada, and lastly with our own present Federal Reserve System, all of which are described in the assignment, will find grounds for optimism on the subject.

Nevertheless, it is well to be forearmed. The last business panic came in 1907. One of those who saw it coming was a shoe manufacturer. Business was then booming, but he had noticed the steady fall of bank reserves in proportion to deposits. He realized that business was overextended. Therefore, instead of building new factories, as others were doing, he turned all available resources into cash. Thus, when the storm broke, he was able to keep his salesmen on the road and also to pick up a lot of accounts that competitors had virtually abandoned. His ready money secured many bargains in raw materials and he kept his labor force intact.

The reader who has acquainted himself with the principles of banking and business, and who is reading the financial columns of the daily papers as well as the Institute's Monthly Letter on Business Conditions, is similarly proof against panics.

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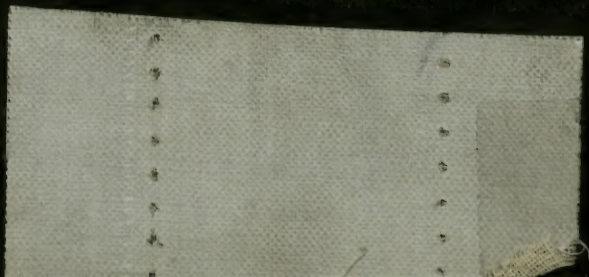

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